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THE BALANCE OF PAYMENTS PROBLEM OF THE UNITED STATES: ITS BACKGROUND, CAUSES AND A POSSIBLE SOLUTION

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OF THE UNITED STATES:

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by

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Submitted in partial fulfillment of
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ABSTRACT

The United States, while enjoying the highest level of prosperity in its history, is, at the same time, faced with the possible loss of its monetary gold reserves due to a chronic deficit in its International Balance of Payments. Actions have been taken to eliminate the deficit in the balance of payments. These, however, if successful, offer only a short term solution to the problem. What is required is a solution which will not only assist the United States in eliminating the deficit, but will also prevent the annual recurrence of balance of payments crises. This paper discusses the Balance of Payments problem, its background and causes and proposes one long-range solution to the current problem.

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CHAPTER I

INTRODUCTION

With the late summer of 1945, the free world rejoiced at the successful conclusion of World War II. As must happen in the wake of any catastrophe, rejoicing soon gave way to the grim task of reconstruction. If the free world were to continue to exist, it must rebuild. But where to turn for the wherewithal to carry out the massive reconstruction? The United States, untouched by bombings, a veteran of only four years of war as compared to her allies' six years, a United States suddenly affluent with the wealth accumulated from the years as the sole economically productive country of the world, was the natural choice. The United States accepted the task and, with it, the leadership of the free world.

Today, however, the United States finds her position as economic leader of the world threatened. There exists a "gold problem." What is this "gold problem" which, suddenly, threatens our economic well-being? How could the United States possibly be in economic difficulty with the greatest gross national product in the world, and every indication of even larger gross national products in the future? Further, why has the United States world economic position so drastically changed in the past ten years? It is the purpose of this paper to examine the problem and to propose one course of action which offers a solution.

CHAPTER II

THE GOLD STANDARD

Today, gold is one measure of a nation's economic well-being. Its movement into and out of a nation is the temperature by which the economic physician can measure the patient's economic health. Although the basic function of money as a medium of exchange has remained unchanged, the forms of money have evolved over the ages from commodity money to representative coinage, from coins to paper currency, and from paper currency to deposits.[1] Whatever its form, money is and has been the lifeblood of trade. Before the trade can be completed, an agreement must be reached by the participants on the value of the money involved. A standard must be agreed upon. Prior to the nineteenth century, trade was carried out in the money of the major trading power, hence no additional standard was required. This system was so popular that it was not until the nineteenth century that the majority of the nations of the world began coinage of national currencies. The birth of national currencies demanded that, if trade was to continue smoothly, some standard for equating national currencies must be agreed upon. Gold and silver, in themselves long popular as money, became the standards, with gold the most popular. The gold standard was born. The use of gold or the gold standard is then a fairly recent development, beginning as it did with the appearance of individual national currencies. Table I is a chronology of gold standard adoption by the major countries of the world.

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[1]Federal Reserve Bank of San Francisco, _The Search for Certainty in an Uncertain World_ (San Francisco: 1962), p. 12.

TABLE I

DATES OF ADOPTING GOLD STANDARDS

Country	Year	Country	Year
Great Britain	1816	Holland	1875
Germany	1871	Uruguay	1876
Sweden	1873	United States	1879
Norway	1873	Austria	1892
Denmark	1873	Chile	1895
France	1874	Japan	1897
Belgium	1874	Russia	1898
Switzerland	1874	Dominican Republic	1901
Italy	1874	Panama	1904
Greece	1874	Mexico	1905

Source: Federal Reserve Bank of San Francisco, The Search for Certainty in an Uncertain World (San Francisco: 1962), p. 10.

Under the international gold standard, each country legally defines its monetary unit in terms of a given gold content. Secondly, the monetary authorities freely buy and sell gold at the official price set. Finally, a par or mint rate of exchange between any two gold standard currencies, equal to the ratio of their gold contents or the ratio of the prices of gold in each currency, is established.[2]

Under this standard, a country paid for its international purchases with an outflow of gold and received in payment for its sales an inflow of gold. Ideally, the outflows are matched by inflows, but seldom does the ideal occur. When an outflow exceeds an inflow, this deficit is financed with the sale of gold reserves. Under what has been called the "classical" gold standard, automatic adjustments would take place to prevent the ultimate loss of all of any country's gold reserves. With the outflow of gold, the domestic money supply would shrink. As the money supply shrinks, prices should fall due to the same amount of business being transacted with less money. The decline in domestic prices relative to foreign prices should make importing less attractive, while making domestic goods more attractive to foreign markets. Following the price decline in the deficit country, there should occur a similar cost decline since wages should fall, thus further improving the competitive position for the deficit country.

In addition, with the foreign purchase the buyer's deposits fall, causing an equivalent loss in bank reserves. With the fractional reserve system, the loss causes a reduction of deposits by a multiple of the

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[2]Delbert A. Snider, Introduction to International Economics (Homewood, Illinois: Richard D. Irwin, Inc., 1963), p. 188.

loss. This will be accomplished by a reduction in bank loans and investments. Security prices will fall due to bank sales and interest rates will rise with money more scarce. This will tend to reduce the level of production and employment which will tend to further force down prices of finished goods and labor. This will further serve to improve the deficit country's trade position and tend to restore a balance between inflow and outflow of gold.

It is expected that a similar but opposite reaction to the deflationary trend in the deficit country is taking place in the surplus country. Inflationary actions of prices, costs and banks should serve to reduce the inflow of gold and to bring flows into balance.[3] Thus, the gold standard offered and appeared to provide an "automatic" system for maintaining a balance between a nation's expenditures and receipts.

From 1879 to 1914, the world enjoyed prosperity, a prosperity attributed by many to an adherence to a gold standard. However, in actuality, banks did not completely play the game by the rules. While the majority of the central banks did raise interest rates when faced with gold outflow, they proved to be loath to lower them at the onset of inflow. Further, due to the long run expansion taking place, gold losses and high interest rates did not have as great a depressive effect on world economy as theorized. The success of the gold standard during the latter part of the nineteenth century and the early twentieth century can be attributed in great part to the fact that Great Britain and the pound sterling provided the economic and financial strength around which the system revolved, and that the rate of change in prices, income and

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[3] Federal Reserve Bank of San Francisco, _op_. _cit_., p. 15.

business activity in the various countries was quite closely synchronized.[4]

World War I demonstrated the critical inadequacy of the gold standard and was the beginning of its abandonment as the prevailing standard in international trade, a process which took about twenty-two years. In time of war, it is obvious that the productive resources of the belligerents will be channeled, for the most part, into war productions. Exports drop to almost zero while imports rise equivalently. If a nation were to adhere to the gold standard under these conditions, her reserves would be exhausted in a short period of time. The United States was the only major belligerent to remain on anything approaching a gold standard during the war.

By 1920, most nations had returned to the gold standard or to an approximation of it. This was the gold exchange standard by which countries held as their reserves currencies of countries on the gold standard. This encouraged the accumulation of short term funds in depository countries. Great Britain, with a high interest rate, received most of this flow. The short term funds, easily redeemable, posed a danger to the depositing country which was realized with the crash of 1929. The sudden movement of short term funds, occasioned by the panic, forced Great Britain off the gold standard in 1931.[5]

In contrast to the British, the United States departure from the gold standard was brought about by domestic causes. The Great Depression

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[4]Federal Reserve Bank of San Francisco, op. cit., p. 18.

[5]Federal Reserve Bank of San Francisco, op. cit., p. 25.

brought to the United States falling prices, reduced income and a virtual collapse of the banking system. The solution to these domestic problems was thought to be the devaluation of the dollar. Accordingly, in 1934, after several months of daily price adjustments, the price of gold was fixed at $35.00 per ounce as compared to the previous price of $20.67 per ounce. Exports of gold were suspended and individuals were forbidden to hold gold.

The departure of the United States from the gold standard left a group consisting of France, the Netherlands, Italy, Belgium, Switzerland and Poland adhering to the gold standard. This "gold bloc," however, suffered a rapid demise in 1936 when France, Switzerland and the Netherlands devalued their currencies.

The last international effort, prior to World War II, to achieve stability in international trade through cooperation in currency control was the Tripartite Agreement, signed by Great Britain, France and the United States in 1936. Under the provisions of the agreement, the signatories pledged avoidance of exchange rate fluctuations and competitive exchange depreciation. The agreement was further strengthened by the subsequent joining of the Netherlands, Belgium, and Switzerland. The agreement operated effectively, achieving stability of exchange rates until the outbreak of the Second World War, at which time it ceased to be operative.[6] The outbreak of World War II signaled the end of one era and the beginning of another. It marked the emergence of the United States as a world leader, both economically and militarily. It also marked the beginning of the problems we face today, the balance of payments deficit and the gold outflow.

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[6]Federal Reserve Bank of San Francisco, op. cit., p. 21.

CHAPTER III

THE PROBLEM

Whenever a consumer spends more than he earns, he must somehow meet the difference between his expenses and his wages. He will usually do this by drawing on his savings or by borrowing. If his reputation is good, his creditors will accept his note. The government in its domestic financial operations is similar to the consumer. It matches its expenditures with taxes, and when a deficit exists, it offers a promise to pay and we, the taxpayers, accept these promises, and they become the National Debt.

In the field of international trade, a similar comparison exists between the consumer and the nation. The nation spends money abroad in the form of purchases (imports), loans or grants and receives money in payment for exports and profits from investments. When spending exceeds receipts a deficit exists. It is financed with outright payments from the nation's gold reserves or with promissory notes. These promissory notes are the dollars which foreign governments hold in bank balances rather than trading for gold. When a nation's expenditures balance against its receipts, it is said to have its international payments in balance. When expenditures outweigh receipts, it is said to have an international balance of payments deficit. When the converse is true, a nation is said to have an international balance of payments surplus.

The International Balance of Payments is an accounting statement which gives a picture of the overall transactions of any country in the international economy over a specific period of time. It is a summary of the money value of all exchanges and transfers of goods and services

and evidences of debt or ownership between residents, businesses and government and other institutions of one country and the rest of the world for a given period of time.[1] As an accounting statement it is a listing of debits and credits of nations. Debits give rise to claims for payment against a resident, business or government of the country by someone outside the country, and credits result in claims for payment by domestic residents or institutions against foreign interests. Figure 1 is a sample of the United States' Balance of Payments account. As an accounting statement, debits and credits must balance. When debits exceed credits, the balance is obtained by a change in the monetary reserve assets which are represented by gold, or changes in the position of the United States in the International Monetary Fund. However, the changes in gold reserves or in the International Monetary Fund position do not generally represent the complete adjustment factor between debits and credits. Foreign banks, individuals and governments usually hold a large amount of dollars in the form of bank accounts, rather than cashing them in for gold. These dollar holdings will be found as a credit entry in the short term component of the capital account. The algebraic sum of gold movements and short term capital give the numerical picture of the balance of payments deficit or surplus. They indicate the method of financing the deficit or surplus. Table II is a representation of the status of the United States' balance of payments from 1947 to 1963.

At the end of World War II, the United States stood as the only relatively stable country in the world. Western Europe, marked by the six years of war, with most of its capital and capital-producing

[1]Snider, op. cit., p. 134.

MODEL BALANCE OF PAYMENTS

	Debit	Credit
I. Current account:		
A. Merchandise trade:		
1. Merchandise imports	x	
2. Merchandise exports		x
B. Service transactions:		
1. Transportation:		
a) Rendered by foreign vessels, airlines, etc. ...	x	
b) Rendered by domestic vessels, airlines, etc. ..		x
2. Travel expenditures:		
a) In foreign countries	x	
b) By foreigners in home country		x
3. Interest and dividends:		
a) Paid to foreigners	x	
b) Received from abroad		x
4. Banking and insurance services:		
a) Rendered by foreign institutions	x	
b) Rendered to foreigners by domestic institutions		x
5. Government expenditures:		
a) By home government abroad	x	
b) By foreign government in home country		x
II. Capital account:		
A. Long-term:		
1. Purchase of securities from foreigners*	x	
2. Sale of securities to foreigners*		x
B. Short-term:**		
1. Increase of bank and brokerage balances abroad	x	
2. Decrease of foreign-held bank and brokerage balances in home country	x	
3. Increase of foreign-held bank and brokerage balances in home country		x
4. Decrease of bank and brokerage balances abroad		x
III. Unilateral transfers:		
A. Private:		
1. Personal and institutional remittances to non-residents	x	
2. Remittances received from abroad		x
B. Governmental:		
1. Grants, indemnities, and reparations made to other countries	x	
2. Grants, indemnities, and reparations received from other countries		x
IV. Gold account:		
A. Import of gold and increase of earmarked gold abroad***	x	
B. Export of gold and increase of earmarked gold for foreign account***		x

*Includes new issues, transactions in outstanding issues, and transfers resulting from redemption and sinking-fund operations.

**Also includes currency holdings, acceptances, and other short-term claims not listed.

***"Earmarked" gold is gold physically held in one country for the account of another.

Source: Snider, Delbert A., Introduction to International Economics, p. 143.

FIGURE I

TABLE II

U. S. BALANCE OF PAYMENTS

	Goods and Services (Net)	Private Remit-tances (Net)	Private Long Range Capital Total	Gov't Capital Unilateral Transfers (Net)	Misc. Total	Total Balance Surplus ( ) Deficit (-)
	Current Acc't					
1947	11,529	-669	- 896	-6,167	770	4,567
1948	6,440	-683	- 962	-4,852	1,062	1,005
1949	6,149	-521	- 621	-5,758	926	175
1950	1,779	-444	-1,048	-3,719	148	-3,580
1951	3,671	-386	- 740	-3,262	412	- 305
1952	2,226	-417	- 900	-2,508	553	-1,046
1953	386	-476	- 322	-2,196	456	-2,152
1954	1,828	-486	- 713	-1,683	- 496	-1,550
1955	2,009	-444	- 674	-2,352	316	-1,145
1956	3,967	-530	-1,961	-2,497	86	- 935
1957	5,729	-543	-2,902	-2,733	969	520
1958	2,206	-540	-2,552	-2,769	126	-3,529
1959	134	-575	-1,589	-2,637	924	-3,743
1960	3,769	-458	-2,114	-3,031	-2,047	-3,881
1961	5,444	-470	-2,143	-3,685	-1,516	-2,370
1962	4,826	-491	-2,495	-3,909	- 117	-2,186
1963	5,485	-143	-3,053	-4,147	- 307	-2,165

Excludes goods and services transferred under military grants.

Source: U. S. Department of Commerce, <u>Survey of Current Business</u>, various issues.

facilities destroyed, turned to the United States for aid. The United States' response can be judged by a study of the period 1947 through 1949. Although the United States enjoyed a substantial net difference of exports over imports, it is not matched by the annual surpluses for these years. A substantial part of the dollars required to support Europe's imports during these years was obtained in the form of loans and grants from the United States. This was mandatory if the dollar short countries of the world were to obtain the imports so badly needed for recovery. At the same time, it served to raise the dollar to a position of prominence among currencies, and made it an acceptable reserve currency in most countries of the world.

Commencing with 1950, the picture begins to change. The United States began to experience deficits rather than surpluses in her balance of payments. Commencing with the inordinately large deficit of 1950 (Korean War), the deficits recur but remain relatively constant (even becoming a surplus in 1957 - Suez) until the drastic rise in 1958 and continue large up to the present. The total result of the balance of payments from 1947 to 1964 has been a deficit which has been financed primarily by reduction of United States gold reserves and increased foreign dollar holding. Table III shows the methods of financing the balance of payments deficits and surpluses from 1947 through 1963. The net result has been a reduction of United States gold reserves from $24.6 billion in 1949 to a level of about $15 billion by mid-February, 1965, and an increase in foreign short term holding to approximately $17 billion.

The significance of this deficit is obvious, if it is financed by the gold reserve. If it is financed by foreign dollar liquid balances,

TABLE III

TOTAL NET BALANCE OF PAYMENTS OF U. S. AND HOW IT WAS FINANCED

	Total Surplus or Deficit(-)	Increase or decrease (-) in Monetary Reserves			Liquid dollar liability (-) to foreigners
		Gold	I.M.F.	Convert. Currencies	
1947	4,567	2,162	153		1,252
1948	1,005	1,530	206		- 731
1949	175	164	102		- 91
1950	-3,580	-1,743	- 15		-1,822
1951	- 305	53	- 20		- 338
1952	-1,046	379	36		-1,461
1953	-2,152	-1,161	- 95		- 896
1954	-1,550	- 298	-182		-1,070
1955	-1,145	- 41	-141		- 963
1956	- 935	306	563		-1,804
1957	520	798	367		- 645
1958	-3,529	-2,275	- 17		-1,237
1959	-3,743	-1,075	40		-2,708
1960	-3,881	-1,702	-741		-1,438
1961	-2,370	- 857	135	116	-1,764
1962	-2,186	- 890	-626	- 17	- 653
1963	-2,165	- 461	- 30	113	-1,787

Source: U. S. Department of Commerce, Survey of Current Business, various issues.

it can continue just as long as these foreign holders of the balances are willing to let these holdings increase. If they decided to withdraw these dollar balances, the drain on the gold stock would be even more rapid. Therefore, the immediate threat to the United States is that of a sudden world wide rush to convert dollars to gold. To guard against this threat two alternatives are available. First, increase the gold reserve of the United States. However, due to the relatively fixed supply of gold in the world, this is a practical impossibility. Second, by selected economic measures, restore faith in the dollar by indicating to the world that the United States is not taking advantage of her position as a reserve currency power to finance her own expansion by deficit operations. To accomplish this, immediate reduction of the deficit is mandatory.

It is doubtful that the immediate aim of the United States policy should be to become a surplus country. Such an eventuality under the present world system would cause the repatriation of the foreign dollar balances and remove the liquidity upon which the expansion of international trade has been based since 1945. This would effectively set the free world back in time twenty years.

Clearly then, the International Balance of Payments problem must be treated in two phases. First, the Short Term solution, a way to eliminate the deficit and restore confidence in the dollar. Second, the Long Term solution, a change in the present system, or the inception of a new system which could guarantee the liquidity required for expanding world trade, a liquidity not based upon the currency of any one nation. The succeeding chapters will investigate these two phases of operation.

CHAPTER IV

ACCEPTABLE SHORT TERM SOLUTIONS

In order to cure an ill, the cause must be discovered. This is equally true in the case of balance of payments deficits. A deficit is synonymous with disequilibrium, but the type of disequilibrium decides the course of action to be taken. Classically, there are three types of disequilibrium, Monetary, Cyclical and Structural, and each is treated in a fashion peculiar to itself.[1]

Monetary disequilibrium occurs when prices and costs in one country are too high relative to costs and prices in competing countries. This condition can be treated by deflation of prices, exchange depreciation, or a combination of the two.

Cyclical disequilibrium is a deficit in current account caused by depression in other countries. This condition caused as it is by factors outside of the deficit country can best be corrected by measures taken by the depressed country, supported by concurrent efforts of the deficit country to maintain income and price levels by fiscal measures. An alternative corrective measure would be the granting of aids and grants to the depressed country.

Structural disequilibrium is based on shifts in international demand or supply of productive agents or goods and services. This sort of disequilibrium can take two forms common in this generation with different corrective measures for each. In the first case, where the productive capital is destroyed by war or other catastrophe, the nation is

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[1] Snider, _op. cit._, pp. 308-309.

obliged to accept some short term deficit. The best solution in this case is the one practice utilized after World War II, the granting of long term loans and aid to the deficit nation. The second case is that of persistent deficits caused by a technological lag on the part of the deficit country. The solution to this problem is the reallocation of effort or the improvement of existing effort protected by legislation against the more efficient foreign producers.

It is rare when a deficit can be ascribed to any one type of disequilibrium. More often than not, it is a combination of disequilibriums which is at the base of the problem. The need, therefore, exists for the application of selective measures chosen on the basis of the nature of the particular type or types of disequilibrium present and the implications of alternative corrections.[2]

Although the individual causes of the U. S. deficit are virtually inseparable from each other, two general causes can be identified. The first is the industrial growth of Western Europe and Japan. The rapid increase in production and the mastery of low cost methods of production rapidly improved their positions in world markets, increased their exports to the United States and made them attractive to the investment of United States capital. The second cause is the increase in United States military expenditures abroad. Most of the increase in expenditures was in West Germany, the recipient country with the strongest proclivity for running a balance of payments surplus.[3]

Before recommending methods of correcting the balance of payments

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[2]Snider, op. cit., pp. 306-314.

[3]Committee for Economic Development, The International Position of the Dollar (New York: May, 1961), p. 43.

deficit problem, it would be well to examine some of the major objectives of United States policy. This would preclude the selection of corrective measures which would be in conflict with these objectives. Some major objectives of United States policy are:

1. To maintain and strengthen the defense of the free world.

2. To promote the economic development of the underdeveloped countries and to make it possible for them to choose paths of development that do not leave them subject to external domination.

3. To maintain a strong and growing domestic economy.

4. To maintain and strengthen a multilateral world trade and payments system as free as possible of restrictions.

5. To see the remainder of the free world maintain strong and prosperous economies and where appropriate to assist in this task.[4]

Keeping in mind the national foreign policy, the following steps can be taken by the United States to balance the payments and remove the deficit. These measures can be divided into two broad categories:

1. Measures to be taken by the United States independently.
    a) Maintain internal price stability. While not guaranteeing an improvement of the international position, it will prevent it from deteriorating.
    b) Increase productivity, especially in industries in competition with foreigners.
    c) Selective reduction of prices as a result of increased productivity. In conjunction with increase in productivity, this should provide an increase in exports.

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[4]Committee for Economic Development, _op_. _cit_., p. 48.

d) Reduction of overseas investment and travel. Keeping in mind the United States' advocacy of freely flowing capital and the rights of citizens to travel, this step must be of an admonitory nature except as a last resort.

e) Promotion of exports.

f) Reduction of military expenditures abroad.

g) Conditioning of nonmilitary loans and grants upon procurement from United States' sources.

2. Measures to be taken in cooperation with other nations or by other nations unilaterally.

a) Redistribution of defense burden in NATO.

b) Increase of aid by surplus nations to developing countries.

c) Reduction of trade and import restrictions.

d) Appreciation of foreign currencies.[5]

While the foregoing measures will tend to bring the international payments of the United States into balance, they will not guarantee an improvement of the United States' liquidity position. Since confidence in the liquidity of the United States is essential to prevent a sudden drain on already limited gold reserves, any improvement of United States' capability to meet drains will automatically lessen the possibility of such drains. The following measures will serve to improve the liquidity position:

Interest Rate Policy: An increased interest rate will tend to limit the flow of short term funds to the higher interest countries of the world. The risk of impeding the growth of the domestic economy by

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[5]Committee for Economic Development, *op. cit.*, pp. 50-61.

this step must be recognized. Therefore, the use of this measure may be better reserved for later emergency use.

<u>Gold Backing Policy</u>: Although gold is not a part of the domestic money supply, Federal Reserve Banks are required to maintain gold holding equal to 25 per cent of total note and deposit liabilities which now amounts to $12 billion. Removal of this requirement would increase liquidity and strengthen the position in a painless fashion and hence, is the best first step to be taken.*[6]

<u>Prepayment of Claims on Foreign Countries</u>: Table IV illustrates the amounts owed the United States Government. Any prepayment of these claims will improve the current liquidity position.

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*Improvement of the liquidity position implies two things: First, increasing our ability to meet a drain on our reserves arising from the conversions of dollars into gold or foreign currency and second, decreasing the possibility that such a drain will occur.

[6] Committee for Economic Development, <u>op</u>. <u>cit</u>., pp. 50-61.

CHAPTER V

PRESIDENTIAL ACTION TO REDUCE THE DEFICIT

In January, 1965, with preliminary figures indicating a third successive year of balance of payments deficits of $3 billion or more, President Lyndon B. Johnson proposed a two part program to reduce the deficit and strengthen the world position of the dollar. The first part of this program was directed at immediately improving the United States' liquidity position. On 28 January, 1965, in his Economic Message to the Congress, President Johnson recommended the removal of requirement for the Federal Reserve Bank to maintain a gold reserve of not less than 25 per cent against its deposits. The approval of this recommendation by the Congress on 10 February, 1965, served to make available $5 billion of gold for meeting international commitments. It also served to reassure the world that the United States still stood ready to honor her agreement to redeem dollars for gold at $35 an ounce.[1] The second part of the President's program also occurred on 10 February, 1965. On that date, the President addressed a message to Congress "... relative to Review of International Balance of Payments and Our Gold Position."[2] This message first stated that the position of the United States' dollar was strong, and further stated that the convertibility of the dollar would continue. Finally, the message set forth the

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[1] U. S. Senate, Committee on Banking and Currency, Gold Reserve Requirements, Report No. 65, 89th Cong., 1st Session, 1965, p. 1.

[2] U. S. Congress House of Representatives, Review of International Balance of Payments and Our Gold Position, Document No. 83, 89th Cong., 1st Session, 1965, p. 1.

following ten steps for overcoming the deficit in U. S. Balance of Payments:

1. Extend the interest equalization tax two additional years beyond December 31, 1965 and broaden its coverage to non-bank credit of 1 to 3 year maturity.

2. Application by the President of the interest equalization tax to bank loans of one year or more.

3. Receipt of assurances from the Canadian Government that their policies would be directed toward limiting capital outflows to those required for the maintenance of a stable level of Canada's foreign exchange reserves.

4. To further limit the flow of bank loans abroad, enrollment of the banking community in a major effort to limit their lending abroad, this enrollment to be accomplished by the Chairman of the Board of Governors of the Federal Reserve System and the Secretary of the Treasury.

5. Legislation to exempt from antitrust laws bankers who are cooperating pursuant to the foregoing, where such cooperation is vital to the national interest.

6. In an effort to reduce the outflow of business capital, direction to the Secretary of Commerce and the Secretary of the Treasury to enlist the leaders of American business in a national campaign to limit their direct investments abroad, their deposits in foreign banks and their holding of foreign assets until the country's international accounts balanced.

7. To minimize foreign exchange costs of defense and aid programs, direction to the Secretary of Defense, the Administrator of AID and others to cut overseas dollar costs to the bone.

8. To limit outflow of tourist dollars, legislation to limit the duty free exemptions of American tourists returning to the United States.

9. To earn more trade dollars, redoubling of efforts to promote exports.

10. To attract more investment dollars from abroad, new tax legislation to provide incentives for foreigners to invest in the United States.[3]

In choosing from the measures available to him (Chapter IV), it is noteworthy that the President chose such measures as would cause no immediate international economic effects. In addition, no attempt was made to enlist the support of foreign governments. At a time of dollar crisis, the President chose to gamble that a substantial reduction of the deficit could be accomplished by these limited unilateral measures. The tenor of the message left no doubt that, in presidential opinion, the lion's share of the responsibility for the large 1964 deficit rested on the shoulders of the bankers and businessmen. In view of this, it is remarkable that at a time when a firm brake on capital outflow would seem to be the only course, the President eschewed coercion and appealed to businessmen and bankers to support the program on a voluntary basis. That is not to say that the positive threat of restrictive measures did not loom behind the President's request.

In recognition of this threat of legislative restrictions, the reaction of bankers and businessmen was virtually immediate. By the end of the first quarter of 1965, the outflow of dollars was reported to have been reduced to a trickle, from a $6 billion annual rate to $2

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[3]U. S. Cong., H. R., Doc. No. 83, op. cit., pp. 2-3.

billion at an annual rate.[4] At the same time, the return flow of dollars was termed massive.[5] The reversal of the fortunes of the dollar was even more apparent in the reaction of European economic circles. From discussion of a dollar glut prior to February 10, by mid-April the talk was of dollar shortage.[6] The 90 day interest rate on the Euro-dollar (dollars on deposit in banks overseas which are lent and held abroad) rose from 4.5% in February to 4.75% in April.[7]

Although possibly premature at such an early date, we may state that the United States has demonstrated to the world that it is capable of adjusting its balance of payments, at least in the short run. If the trend of March and April, 1965, continues, a deficit for 1965 of only $1 billion is possible. Such an event will no doubt strengthen the position of the dollar. Foreign dollar balance holders should be encouraged to continue holding dollars. But, for all these apparent benefits, is the United States in any way guaranteed that she will not face another balance of payments problem in six months or even a year?

Within the current international monetary system, so long as the United States continues the role of reserve currency nation and so long as foreign dollar liabilities exceed U. S. gold reserves, the United States will face the risk of recurring balance of payments problems.

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[4] Associated Press dispatch, The Monterey (California) Herald, April 7, 1965.

[5] "Business Around the World," U. S. News and World Report, Vol. LVIII No. 14 (April 5, 1965), p. 105.

[6] "Tomorrow," U. S. News and World Report, Vol. LVIII No. 15 (April 12, 1965), p. 25.

[7] Walter Lippmann, "President's Dollar Defense Shows Strength of American Economy," Editorial Page, The Los Angeles Times, April 11, 1965.

The danger of the obvious solution, to become a surplus country and drain dollars and, hence, the liquidity from international commerce has already been discussed. Clearly the real solution, the long range solution, to this problem does not lie within the restrictive boundaries of the existing international monetary system. We must seek a new system which, in the words of Arthur K. Watson, Chairman of IBM World Trade Organization, "...will give the free world elbow room to grow without these unending balance of payments crises."[8]

The following chapter will examine one such system.

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[8] "Looking for Change," Time Magazine, Vol. 85 (March 12, 1965), p. 85.

CHAPTER VI

A LONG RANGE SOLUTION

A. Introduction

During the first week of February, 1965, General Charles De Gaulle upset the financial world with a call for a return to the gold standard. Coming as it did on the heels of the Treasury announcement that the U. S. 1964 payments deficit was approximately $3 billion, this proposal certainly did nothing to enhance the United States' position. However, rather than condemn the General for his betrayal of his 1963 pledge to support the present international monetary system, perhaps he should be applauded for awakening the world to the need for revision or replacement of that system.

In June, 1959, Yale economist Robert Triffin unveiled a plan to overcome what at that time he envisioned as the failings and dangers of the current International Monetary System. Professor Triffin published his proposal in book form in 1960 under the title "Gold and the Dollar Crisis."[1] In testimony before the Joint Senate-House of Representatives Economic Committee in October 1959, Professor Triffin offered his proposal and at the conclusion of the committee hearings his "most constructive suggestion" was included in the committee report and, in addition, was forwarded to the President, Secretary of the Treasury, Chairman of the Board of Governors of the Federal Reserve and the Managing Director of the International Monetary Fund.[2] However, 1959 was a year when we had experienced only one balance of

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[1]Robert Triffin, Gold and the Dollar Crisis (New Haven: Yale University Press, 1960).

[2]*Ibid.*, p. 190.

payments yearly deficit. The annoyance of continuous deficits was only beginning. In addition, the country was approaching a presidential election. Attention was focused on the possible candidates of the Democratic party. Western Europe was embarked on the road to prosperity and was hardly inclined to consider anything which might disturb the status quo. So the nation and the world cannot honestly be blamed for ignoring the Cassandra-like voice of Professor Triffin.

Today, however, after six years of United States payments deficits and various attempts at their elimination, the attention of the world is being directed toward the discovery of some new system to do away with this perennial problem. The solution proposed by Professor Triffin in 1959 is receiving renewed attention. Among its proponents are England's Prime Minister Wilson, Greece's Central Bank Chief Xenophon Zolotas and Bank of Italy Governor Guido Carli.[3] The purpose of the remainder of this paper will be to examine Professor Triffin's proposal, its advantages and disadvantages.[4]

B. The Keynes Plan

As Professor Triffin freely admitted, his proposal found its conception in the Keynes Plan for an International Clearing Union as originally proposed in April of 1943 and later incorporated into the proceedings of the United Nations Monetary and Financial Conference at Bretton Woods in 1944. In fact, the Triffin proposal accepts the basic framework of the Keynes Plan, but imposes stronger limitations upon it, in

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[3]"A Cry for Change," Time Magazine, Vol. 85 (April 16, 1965), p. 90.

[4]Except as otherwise noted, the remainder of this paper will utilize "Gold and the Dollar Crisis" as its source.

an effort to overcome the outstanding objections to the plan. Let us first, then, examine the important features of the Keynes Plan.

As previously discussed, the major danger in the international monetary system today centers around the use of national currencies as international reserves. The keystone of the Keynes Plan was the replacement of these reserves of national currencies with an international currency. Under the Keynes' International Credit Union all members would be committed to accept in lieu of gold and without limit transfers of this international currency called bancor to their credit in the books of the Union in full settlement of any balances due them from any other members. No member state would be entitled to demand gold from the Clearing Union against its balance of bancor. This then endowed the Credit Union with unlimited lending capacity since

> If no credits be removed outside the clearing system, but only transferred within it, the Union can never be in difficulty as regards honoring checks drawn upon it. It can make what advances it wishes to any of its members with the assurance that the proceeds can only be transferred to the clearing account of another member. Its sole task is to see to it that its members keep the rules and that the advances made to each of them are prudent and advisable for the Union as a whole.[5]

In the foregoing can be recognized the essential principle underlying the development of national banking systems.

This acceptance of an unlimited credit account would not be burdensome to the creditor country, for it would have the same effect as the importation of gold in that it would also indicate possession of a purchasing power, while at the same time signifying voluntary abstention

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[5]Proceedings and Documents of the United Nations Monetary and Financial Conference (Washington: Government Printing Office, 1948), Vol. II, pp. 1548-1573.

from the use of this power. Unlike the importation of gold, however, this growing credit account would not withdraw the purchasing power from circulation or exercise a deflationary or contractionist pressure on the world. This substitution of a credit mechanism for gold hoarding makes the analogy to a national banking system complete.

No nation would be obliged to commit themselves directly to the support of any particular nation or policy or project. The only requirement placed upon the member states is to permit the pooling of their surplus resources with those of other members to be employed on approved projects. At the same time, any member having need of its surplus resources would be free to withdraw them from the pool.

What Keynes proposed then was an international bank whose depositors would be nations and which would be able to function in the same manner as the national banks. From a narrowly economic point of view there can be no objection to the plan. However, the main objection to the plan is not economic, but rather, political. This political objection is twofold. First there is the risk that unwise use of the Clearing Union's lending facilities to finance inflationary rather than expansionist policies throughout the world, would reduce the value of the creditor accounts. However, if the creditor countries were in agreement with the Union's lending policies, there could hardly be justification for complaint against decisions in which they concurred. The core of the problem lies in the voting procedures of the Union and the loss of sovereignty which might be involved. The safeguards to allay these fears, provided in the Keynes Plan were, however, "totally inadequate and little ingenuity was shown by any of its negotiators in devising new ones."[6]

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[6] Triffin, op. cit., p. 93.

The second objection lies in the anonymity of the Union's lending. This anonymity, while one of the virtues of the plan, at the same time results in the loss of political influence and bargaining power acquired by the lending nations in direct negotiations with the borrowers.

The political nature of these objections must be appreciated if a workable solution is to be obtained in this nationalistic world. Distinction must be made between what might be accomplished by world-wide agreement and what may prove achievable only on a regional scale within smaller and more homogeneous groups of interdependent countries.

C. The International Monetary Fund

The key point of the Triffin plan would be the substitution of International Monetary Fund balances for balances in national currencies, i.e., dollars and pounds sterling in all member countries' monetary reserves. Therefore, it would be well to review at this point the purposes and functions of the IMF.

The purposes of the IMF include:

a) International monetary cooperation

b) Expansion and balanced growth of international trade

c) Maintenance of exchange stability and orderly exchange arrangements among members

d) The establishment of a multilateral system of payments for current transactions and the elimination of exchange restrictions.

Each member is expected to declare a par value for its currency expressed in terms of gold or U. S. dollars and to maintain the buying and selling rate of its currency within one per cent of the par value. Each member has a quota, which determines the amount of its subscription, measures the extent to which the member may have access to the Fund's resources and governs the member's voting power. This quota is usually

composed of 25 per cent gold and 75 per cent the member government's currency.

The Fund sells to a member needed currencies in return for that member's currencies. The amount of such sales, called drawings, is limited to the "gold tranche," the amount of the member's subscription in gold. Drawings with the "tranche" are permitted only if and to the extent that the quantity of that member's currency has fallen below the 75 per cent of the original subscription. Drawings which would bring the Fund's holdings of a member's currency above 100 per cent, but less than 125 per cent of its subscription, are given liberal treatment. However, drawings in excess of this limit must be accompanied by proof of a member's efforts to solve its problems.

The Fund, in appropriate instances, will provide compensatory financing of export fluctuations. Drawings made under these arrangements are expected to be repurchased by the member with gold or currencies needed by the Fund over a period of not more than 3 to 5 years.[7]

It is easily seen that the IMF contribution to world liquidity is relatively static, determined as it is by members' quotas. With the rapid growth of trade and the necessity for concurrent growth in monetary liquidity, the only method by which the Fund can keep pace is by an increase in members' quotas. On 17 March, 1965, President Johnson requested approval of Congress for an increase in the United States' IMF quota by the amount of $1.035 billion.[8] The last general quota increase

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[7] U. S. Congress, House of Representatives, <u>Ninth Special Report of the National Advisory Council on International Monetary and Financial Problems</u>, Document No. 60, 89th Congress, 1st Session, 1965, pp. 4-5.

[8] U. S. Congress, House of Representatives, <u>A Bill to Amend the Bretton Woods Agreements Act to Authorize an Increase in the International Monetary Fund Quota of the United States</u>, Document No. 121, 89th Cong., 1st Session, 1965.

took place in 1959. The current proposed general quota increase will provide the fund with an additional $5 billion, if subscribed to by all members. It is clear that this will just provide operating cash for a while, until the next quota increase is demanded.

D. The Triffin Plan

The Triffin Plan is intended to preserve the core of the Keynes Plan mechanism, while countering the objections raised against it. It would retain IMF accounts as a fully multilateral means of settlement, thus simplifying the lending and borrowing operations of the institution and guaranteeing the interconvertibility of all member currencies.

The lending capacity of the IMF would be based upon the accumulation of credit accounts by member nations, as an integral part of their monetary reserves along with, and fully equivalent to, gold for international transactions. This does not require that the Fund be endowed with unlimited, and hence possibly inflationary, lending capacity, nor require that members commit themselves to accepting unlimited credit accounts.

The lending capacity can be limited to the creation of credit accounts sufficient to guarantee an adequate level of world liquidity. The simplest method for accomplishing this end would be to limit net lending for any twelve-month period to an amount which, together with gold production, would increase world reserves by possibly 3 to 5 per cent. The exact figure would be calculated and negotiated.

To finance the lending, an accumulation of Fund balances by the members would be required as a part of the annual increase in their total reserves. Most nations now hold foreign currencies as a part of their monetary reserves. This is done first for the convenience and

lower cost incidental to the use of key currencies rather than gold in international transactions, and second the earnings derived from maintaining a portion of the reserves in the form of foreign exchange. Inherent in this practice is the risk of exchange fluctuation, inconvertibility, blocking, or even default. The shift from national currency balances to Fund balances would preserve the advantages and diminish the disadvantages of this practice. Fund earnings would be distributed among members pro rata of their balances. Expressed as they would be in gold units, the danger of inconvertibility would not exist. Balances could at any time be used as freely as gold to make payments to any other member and even non-members.

The advantages of the system should ultimately create a demand for Fund balances, especially on the part of those nations now holding a large portion of their national reserves in foreign currencies. This is not likely though in the early years of operation. In order to finance the lending operation and at the same time maintain full convertibility, the simplest solution is to require members to maintain a certain percentage of their gross monetary reserves in the form of Fund deposits. All members would accept such deposits in settlement of their international claims without limit, but would have the right to convert at any time into gold all deposits accrued to their account in excess of the minimum requirement.

This requirement would replace the present Fund quota system and offer additional advantages to the members. First, the balances so held would be completely liquid and usable in payments and, therefore, could honestly be considered as a part of the members' reserves. Second, the deposit obligations would adjust automatically to expansions or

contractions of the reserve position of each country. Most important, perhaps, is the fact that this increase in minimum Fund deposits requirements would concentrate on countries holding net surpluses and whose currency is most in demand.

Three types of assets would be acceptable to meet the minimum deposit requirements:

1. Net creditor claims previously accumulated on the Fund

2. Other liquid or semi-liquid foreign exchange holdings, i.e., primarily dollar and sterling balances

3. Gold

If gold continues to hold its attraction, it is safe to assume that most nations will prefer to transfer to the Fund a portion of their foreign exchange holdings. If a 20 per cent of reserves figure is assumed, only a handful of countries would be obliged to deposit gold to meet their obligation. At this rate, the Fund would hold approximately half its assets in gold and the remainder in foreign exchange, primarily dollars and pounds. These dollars and pounds represent claims for gold, hence the United States and Great Britain would be considered to be in debt to the Fund for this amount and would be expected to amortize the debt at an agreed annual rate.

In operation, the Fund would credit currency sales to the deposit account of the nation whose currency had been sold. The large gold holdings of the Fund would guarantee the convertibility into gold of any excess of deposits above the required minimum deposit. If as can be expected, the dollar continues to be the most demanded currency and the United States begins to accumulate excess deposits and desires conversion to gold of these excesses the Fund could require extraordinary

amortization of the debt. This would also serve as a safeguard against a scarcity of dollars or pounds in view of the large initial holdings of these currencies.

Having assumed a minimum reserve requirement for the operations of the Fund, the logical progression would be the conversion of all foreign exchange reserves, less immediate operating requirements, to Fund balances. This would cause no change in the Fund gold assets and increase its foreign exchange holdings threefold. This move would expose the Fund to the danger of excessive depletion of its gold resources from two quarters:

1. Direct conversion into gold by members of the excessive deposits over required minimums thus resulting.

2. Later conversion into gold by the countries whose subsequent surpluses are settled through transfers of Fund balances from deficit countries' accounts to the surplus countries' account.

The first danger would easily be offset, as far as sterling balances are concerned, by establishment of the policy that conversion to gold would only apply to Fund balances exceeding the sum of the country's normal per cent requirement plus the balances initially acquired in exchange for the gold inconvertible national currency balances. This would effectively limit convertibility to dollar balances. However, as those countries, primarily the United Kingdom, whose gold inconvertible currencies are held as assets by the Fund, amortize their indebtedness to the Fund, this limitation would gradually be removed. Direct conversion into gold of excessive dollar balances could only be met by extraordinary amortization of United States indebtedness to the Fund.

The remaining danger is diminished by the fact that only 80 per cent

of such transfers would expose the Fund to gold payments since 20 per cent of them would increase the minimum deposit requirements of the receiving countries. In addition, the option of the Fund to claim additional amortization from debtors of the balances could bring additional gold resources to the Fund.

It appears feasible then that the proposed system would permit absorption and consolidation of all outstanding foreign exchange reserves. Safeguard of Fund liquidity must be provided against unforeseen conversions of excess deposits into gold and against a widening gap between world gold stocks and the desirable expansion of overall monetary reserves. Three possible methods for protecting the Fund are as follows:

1. Issuance by the Fund of medium term gold certificates payable either in gold or excess deposits and carrying a higher rate of interest than liquid Fund deposits.

2. Authorization for the Fund to raise the per cent deposit requirements uniformly.

3. Impose higher deposit requirements on that portion of each member's reserves which exceeds the average ratio of world monetary gold to world imports.

One further facet of the plan requires examination before concluding, the Fund Lending Operations. These loans should be of two broad categories:

1. Advances or rediscounts undertaken at the initiative of the borrowing country.

2. Open market operations, or investments, undertaken at the initiative of the Fund.

The first category would not differ appreciably from the loans

granted by the Fund today. The second category would involve operations in the financial markets of member countries. These operations would, of course, always be in agreement with the monetary policies of the countries involved in order to protect against exchange and inconvertibility risks.

A primary consideration for Fund investments is the preservation of full liquidity of members' deposits. Since the Fund required deposits can be expected to grow yearly as world reserves increase, the liquidity problem is confined to preservation of convertibility of excess deposits into any currency or gold as desired. This has been amply discussed in the preceding pages.

While it is clear that Professor Triffin's proposal for a new International Monetary System within the existing IMF framework is feasible, it is at the same time, at the very least, visionary. It is a goal toward which to aim. It is doubtful that in this era of ultra-nationalism that any nation will willingly sacrifice any of its sovereignty to such an ultra-international concept. But, as the child must walk before it runs, so also must the world learn.

Most probably, the ultimate acceptance of such a plan will depend in great part upon the success of the smaller modern-day organizations for economic cooperation, such as the European Economic Community.

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